

Introductory Section



ND Retirement and Investment Office

*Teachers' Fund for Retirement
State Investment Board*

Steve Cochrane, CFA
Executive Director

Fay Kopp
Deputy Executive Director

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November 15, 2005

Members of the
North Dakota State Investment Board
North Dakota Teachers' Fund for Retirement Board

Dear Board Members:

With pleasure we present you with the June 30, 2005, Comprehensive Annual Financial Report (CAFR) for the North Dakota Retirement and Investment Office (RIO). The report is a complete review of the financial, investment, and actuarial conditions of the two programs for which you are responsible. Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, rests with the management of RIO.

This CAFR is divided into five sections: the Introductory Section, which contains the administrative organization, the Certificate of Achievement for Excellence in Financial Reporting, and a letter of transmittal; the Financial Section, which contains the report of the Independent Auditors, a narrative introduction and overview in the Management's Discussion and Analysis, the financial statements of the agency, and certain required supplementary information; the Investment Section, which contains a report on investment activity, investment policies, investment results, and various investment schedules; the Actuarial Section, which contains the Actuary's Certification Letter and the results of the annual actuarial valuation; and the Statistical Section, which includes significant data pertaining to RIO.

Generally accepted accounting principals (GAAP) require that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement MD&A and should be read in conjunction with it. RIO's MD&A can be found immediately following the report of the independent auditors in the Financial Section.

RIO is an agency of the State of North Dakota. The agency was created by the 1989 Legislative Assembly to capture administrative and investment cost savings in the management of two important long-standing state programs – the retirement program of the Teachers' Fund for Retirement (TFFR) and the investment program of the State Investment Board (SIB).

Established in 1913, TFFR is one of the oldest retirement plans in the nation. TFFR is a qualified defined benefit public pension plan covered under Section 401(a) of the Internal Revenue Code. North Dakota Century Code Chapter 15-39.1 contains the actual language governing the fund. The plan covers North Dakota public school teachers and administrators. The TFFR plan is funded on an actuarial reserve basis. Benefit funding comes from member and employer contributions and investment earnings. TFFR serves nearly 10,000 teachers from 260 employer groups and pays benefits to more than 5,500 retirees and beneficiaries. High quality member services and outreach programs are offered to members and employers as part of the continuing effort to keep them informed about the retirement program.

The SIB is responsible for setting policies and procedures guiding the investment of \$4.4 billion in assets for five pension funds and 16 other insurance-type funds. Their investments are divided into two investment trust funds and one individual investment account. The following table details the participants in each trust fund:

Pension Investment Pool Participants

Teachers' Fund for Retirement
 Public Employees Retirement Fund
 City of Bismarck Employees Pension Fund
 City of Bismarck Police Pension Fund
 Job Service of North Dakota Pension Fund

Individual Investment Account

PERS Retiree Health Insurance Credit Fund

Insurance Investment Pool Participants

Workforce Safety & Insurance (WSI) Fund
 State Fire and Tornado Fund
 State Bonding Fund
 Insurance Regulatory Trust Fund
 Petroleum Tank Release Compensation Fund
 ND Health Care Trust Fund
 State Risk Management Fund
 State Risk Management Workers Compensation Fund
 Veterans Post War Trust Fund
 Veterans Cemetery Trust Fund
 ND Association of Counties Fund
 ND Association of Counties Program Savings Fund
 City of Bismarck Deferred Sick Leave Fund
 NDPERS Group Insurance Account
 City of Fargo FargoDome Permanent Fund

The pension investment pool is made up of only qualified pension funds whose monies must be invested exclusively for the benefit of their participants. The insurance investment pool is made up of mainly insurance-type funds, but also includes other funds that do not qualify as pension funds and would like to benefit from the cost savings of being pooled with other funds' assets. All of these funds are invested in accordance with the "Prudent Investor Rule."

The pension investment pool was created in July 1989 with the pooling of selected investments of TFFR and the Public Employees Retirement System (PERS). Assets from the City of Bismarck Employees and Police pension funds were added later that same fiscal year. In April 1994, Job Service of North Dakota made their initial contribution to the pool. No changes in participation have occurred in the pension investment pool since that time.

The insurance investment pool began in December 1993 with the pooling of the assets of the WSI, Fire and Tornado, Bonding, Insurance Regulatory, and Petroleum Tank Release funds.

Other additions to this pool have occurred as follows:

- The Risk Management Fund was added in October 1996.
- Both the Veterans Cemetery Trust and the Veterans Post War Trust funds were added during the fiscal year ended June 30, 1998, in August and December, respectively.
- The two North Dakota Association of Counties funds were added during fiscal year 1999, in January and March, respectively.
- The City of Bismarck Deferred Sick Leave and PERS Group Insurance funds were both added in July 1999.
- The ND Health Care Trust fund was added in July 2001 by legislative mandate.
- The City of Fargo FargoDome Permanent Fund was added in October 2002.
- The Risk Management Workers Compensation Fund was added in October 2003.

There have only been two deletions from this pool - the Veterans' Home Improvement Fund, which was added in July 1996 and removed in August 1997, and the National Guard Tuition Waiver Fund, which was added in June 1996 and removed in June 1999.

MAJOR INITIATIVES

- Retirement Program

Proper funding of the retirement program remains a challenge for the TFFR Board. Funding information and details can be found in the Actuarial Section.

While there were no material TFFR plan modifications made by the 2005 Legislative Assembly, during the year, the TFFR Board was involved in the following initiatives:

- ✓ Experience Study - Every five years, the TFFR Board contracts with its actuary to perform an actuarial experience study. The current study indicated that while most actuarial assumptions remain accurate, there were a few that need to be updated in order to reflect the actual experience of our members. The most significant findings were that individual teacher salary increases were higher than assumed, fewer teachers terminated than expected, and more teachers retired when first eligible than assumed. The assumption changes resulted in additional costs and liabilities. To help manage the increased costs, the Board changed the amortization period from 20 years to 30 years, and changed the amortization approach from a level dollar amount to a level percentage of payroll.
- ✓ Asset Liability Modeling Study – Because there is a significant and dynamic relationship that exists between the assets of the system and its future liabilities, every five years, the TFFR Board also contracts with its actuary to perform an asset liability modeling study. The 2005 study indicated it is unlikely that TFFR will be able to develop positive margin over the long term, regardless of portfolio selected. However, after reviewing the risk and return characteristics of a number of portfolios, the Board adopted modest changes. Asset allocation changes were implemented in August 2005.
- ✓ New Pension Administration System - TFFR began a project to replace its outdated mainframe computer system with new pension software in 2004. The goal of the updated system is to improve service to members, increase the reliability of data, provide tools for improving staff productivity, enhance system integration capabilities, and update technology. The project is progressing on time and within budget. The software went into production in September 2005, and will be fully implemented during the 2005-06 year. We believe that over time, TFFR members, employers and RIO staff will all benefit from this state of the art pension administration system.
- Investment Program

The investment markets remained strong during fiscal year 2005. All of the pension funds exceeded their actuarial return assumptions for the year. The insurance funds' returns were highly reflective of their individual asset class exposures and in all cases exceeded their respective total fund benchmarks. Investment details by trust fund can be found in the Investment Section.

During the year, the SIB completed the following initiatives:

 - ✓ Based on client guideline changes, eliminated convertible bonds as an asset class in the insurance investment pool.
 - ✓ Based on client guideline changes, studied real estate investment options for the insurance investment pool and ultimately voted to commit assets to one manager.
 - ✓ Restructured the international equity portfolios in both the pension and insurance investment pools by adding an additional large cap value manager in each and re-mandating a manager to an index exposure in the pension investment pool.
 - ✓ Terminated a duration based manager in the domestic fixed income asset class of the pension investment pool and subsequently reallocated those assets to existing managers.
 - ✓ Hired a private placement debt manager in the domestic fixed income asset class of the pension investment pool.

ACHIEVEMENT AWARDS

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to RIO for its comprehensive annual financial report for the fiscal year ended June 30, 2004. This was the seventh consecutive year that RIO has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

FINANCIAL INFORMATION

RIO is subject to very strict operational controls. Well-established internal controls are in place, segregation of duties is maintained, and an internal audit program is in effect. In addition, an annual external audit is performed and the results are reported to the Legislative Audit and Fiscal Review Committee.

Brady Martz & Associates conducted the external audit under the direction of the North Dakota State Auditor. The auditor's opinion was unqualified for the agency for the year ended June 30, 2005.

The tables below summarize RIO's revenues and expenses for the current and prior fiscal years:

Pension Trust Fund (TFFR)	June 30, 2005	June 30, 2004	Incr/(Decr) \$	Incr/(Decr) %
Additions	\$ 244,833,136	\$ 283,898,141	\$(39,065,005)	(13.8)%
Deductions	89,318,386	84,466,942	4,851,444	5.7 %
Net Increase/(Decrease)	\$ 155,514,750	\$ 199,431,199	\$(43,916,449)	(22.0)%

Additions decreased due to a decrease in net investment income. Deductions increased because the average benefit increased from the previous year, as did the number of retirees receiving benefits throughout the year.

Internal Service Fund	June 30, 2005	June 30, 2004	Incr/(Decr) \$	Incr/(Decr) %
Operating revenues	\$ 2,468,546	\$ 1,896,124	\$ 572,422	30.2 %
Operating expenses	1,881,859	1,496,754	385,105	25.7 %
Non-operating revenue (expense)	(448)	(835)	(387)	(46.3)%
Net revenues (expenses)	\$ 586,239	\$ 398,535	\$ 187,704	47.1 %

Operating revenues increased due to an increase in the overall expenses flowing through the fund and being allocated to the programs; mostly due to the retirement administration software replacement project. Operating expenses increased mainly due to additional costs associated with the software project. Non-operating expenses decreased due to an increase in interest income.

FUNDING STATUS

The overall objective of a pension fund is to accumulate sufficient funds to meet all expected future obligations to participants. The member and employer contribution rates are established by statute, and both are currently set at 7.75%. The rates are intended to be sufficient to pay TFFR's normal cost and to amortize TFFR's unfunded actuarial accrued liability (UAAL) over a period of 30 years from the valuation date. The amortization period used in the previous valuation was 20 years, but it was increased by the Board effective for this valuation. A thirty-year period is the maximum amortization period allowed by GASB 25 in computing the Annual Required Contribution (ARC). The thirty-year period is in common use for public-sector plans and is considered reasonable by the actuary.

In order to determine the adequacy of the 7.75% statutory contribution rate, it is compared to the GASB 25 ARC. The ARC is equal to the sum of (a) the employer normal cost, and (b) the level percentage of pay required to amortize the UAAL over a 30-year period. For this calculation, payroll is assumed to increase 2.00% per annum. As of July 1, 2005, the ARC is 12.12%. This is more than the 7.75% rate currently required by law. The shortfall (the negative margin) between the rate mandated by law and the rate necessary to fund the UAAL in 30 years is -4.37%.

The GASB ARC increased from last year due to the recognition of previous years' actuarial investment losses and changes made to actuarial assumptions, offset by the effect of the changes in the amortization procedures. The increase in the ARC would have been even larger if not for the 13.3% market asset return in fiscal year 2005.

If the 7.75% contribution rate remains unchanged, and all actuarial assumptions are exactly realized, including an 8.00% investment return on the actuarial value of assets, then the UAAL will never be amortized. I.e., TFFR has an infinite funding period.

The funded ratio (the ratio of the actuarial value of assets to the actuarial accrued liability) decreased from last year. The funded ratio at July 1, 2004, was 80.3%, while it is 74.8% as of July 1, 2005. This decrease is due to the two factors cited above. Based on market values rather than actuarial values of assets, the funded ratio improved to 77.9% from 76.4% last year.

The following table summarizes the actuarial valuation of the TFFR plan. A detailed discussion of funding is provided in the Actuarial Section of this report.

	July 1, 2005 (in millions)	July 1, 2004 (in millions)
Actuarial value of assets	\$ 1,469.7	\$ 1,445.6
Unfunded actuarial accrued liability	495.5	354.8
Funded ratio	74.8%	80.3%

INVESTMENT ACTIVITIES

The investment policies and strategies for each of the funds under the SIB can be found in the Investment Section of this report. Each policy is created by the individual fund and presented to the SIB for acceptance. Once accepted, the policy is used as a guide to determine participation in the applicable pools. The policies are designed to provide safeguards on assets while optimizing return based on each fund's risk parameters.

The return information presented in the Investment Section is calculated with the assistance of our consultant, Callan Associates, based on data supplied by our custodian, The Northern Trust Company, and the individual investment managers. The investment return calculations were prepared using a monthly time-weighted rate of return methodology in accordance with AIMR's Performance Presentation Standards, and are subject to independent audit.

PROFESSIONAL SERVICES

Professional consultants are selected by the TFFR Board and the SIB to perform professional services that are essential to the effective and efficient operation of the retirement and investment programs. An opinion from the certified public accountant and the actuary are included in this report. The consultants chosen by the boards are listed in the Introductory Section of this report.

Respectfully yours,



STEVE COCHRANE, CFA
Executive Director/CIO



FAY KOPP
Deputy Executive Director



CONNIE L. FLANAGAN
Fiscal & Investment Officer

NORTH DAKOTA RETIREMENT AND INVESTMENT OFFICE

Mission

The North Dakota Retirement and Investment Office exists in order that:

- ◆ SIB clients receive cost-effective investment services directed at meeting their written financial goals under the Prudent Investor Rule.
- ◆ SIB clients receive investment returns consistent with their written investment policies and market variables.
- ◆ Potential SIB clients have access to information regarding the investment services provided by the SIB.
- ◆ TFFR benefit recipients receive their retirement benefits in a cost effective and timely manner.
- ◆ TFFR members have access to information which will allow them to become knowledgeable about the issues and process of retirement.
- ◆ SIB clients and TFFR benefit recipients receive satisfactory services from the boards and staff of the office.

Administrative Staff



Steve Cochrane, CFA
Executive Director/CIO



Fay Kopp
Deputy Executive Director

Supervisory Staff

Connie L. Flanagan
Fiscal Management

Shelly Schumacher
Retirement Services

Les Mason
Internal Audit

Bonnie Heit
Administrative Services

Gary Vetter
Information Services

NORTH DAKOTA STATE INVESTMENT BOARD

Board Members

Investment Program

Investment Process

The ND State Investment Board believes that an investment program must be built and managed like any good business, with a clear statement of mission, overall objectives, roles and responsibilities, and policies and guidelines. Major issues include:

Asset allocation targets:

- Setting appropriate benchmarks.
- Finding the right managers.
- Monitoring the program.
- Searching for appropriate new opportunities.

To ensure rigorous attention to all aspects of the investment program, the SIB follows an established investment process. This process involves three phases:

- Investment policy development/modification
- Implementation/monitoring
- Evaluation



Jack Dalrymple
Chair
Lt. Governor
Term expires 12/31/08



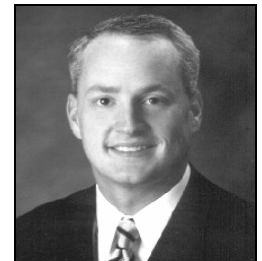
Howard Sage
Vice Chair
PERS Trustee
Term expires 6/30/08



Mark Sanford
TFFR Trustee
Term expires 6/30/10



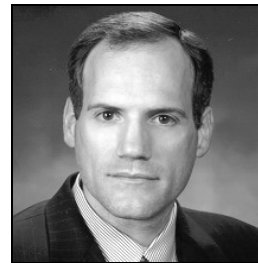
Kelly Schmidt
State Treasurer
Term expires 12/31/08



Jim Poolman
State Insurance Commissioner
Term expires 12/31/08



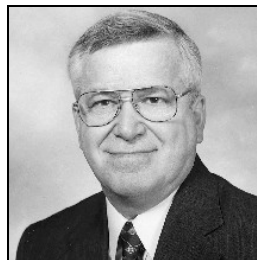
Gary Preszler
University and School Land Commissioner



Sandy Blunt
Executive Director
Workforce Safety & Insurance



Barbara Evanson
TFFR Trustee
Term expires 6/30/09



Ron Leingang
PERS Trustee
Term expires 6/30/09



David Gunkel
PERS Trustee
Term expires 10/31/05



Clarence Corneil
TFFR Trustee
Term expires 6/30/07

NORTH DAKOTA TEACHERS' FUND FOR RETIREMENT

Board of Trustees

Retirement Program

Mission

The mission of the Teachers' Fund for Retirement, a trust fund, is to advocate for, develop, and administer a comprehensive retirement program for all trust fund members within the resources available.

Goals

- To provide a replacement income equal to 60 percent of the final average salary of a career employee who has 30 or more years of credited service.
- To provide ad hoc biennial benefit increases and 2% annual benefit increases to retired members and beneficiaries to provide income protection and assist retirees in accessing affordable health insurance.
- To continue providing state-wide pre-retirement planning services and benefits counseling to members.



Mark Sanford

President

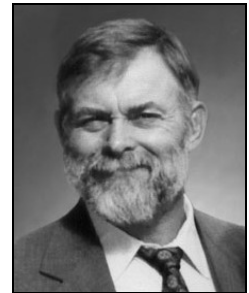
*(represents administrators)
Term expires 6/30/05*



Barbara Evanson

Vice President

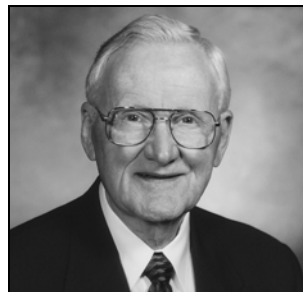
*(represents active teachers)
Term expires 6/30/09*



Mike Gessner

Trustee

*(represents active teachers)
Term expires 6/30/06*



Lowell Latimer

Trustee

*(represents retired teachers)
Term expires 6/30/08*



Clarence Corneil

Trustee

*(represents retired teachers)
Term expires 6/30/07*



Kelly Schmidt

State Treasurer

Term expires 12/31/08



Wayne Sanstead

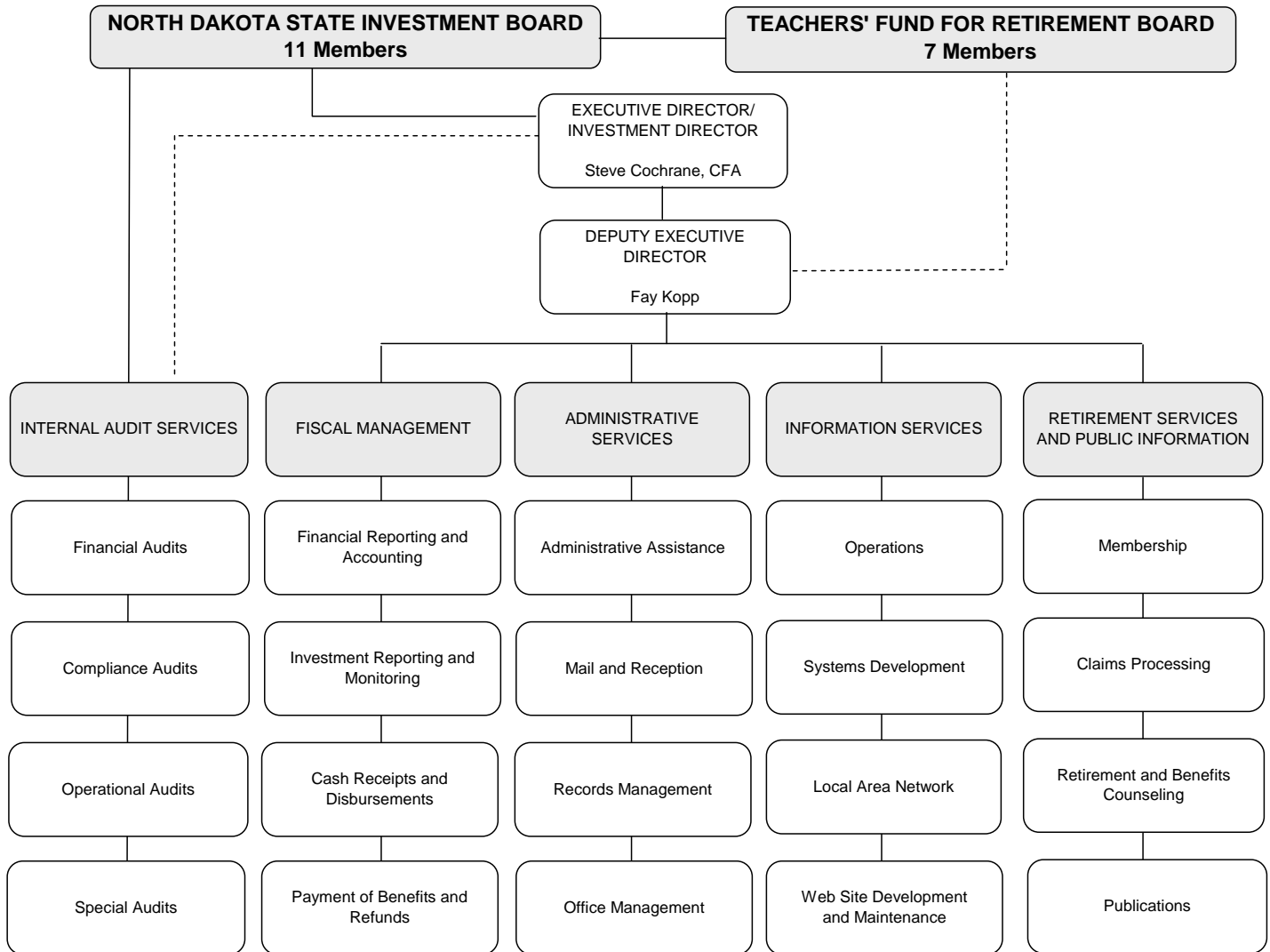
*State Superintendent
of Public Instruction*

Term expires 12/31/08

NORTH DAKOTA RETIREMENT AND INVESTMENT OFFICE

ADMINISTRATIVE ORGANIZATION

JUNE 30, 2005



NORTH DAKOTA RETIREMENT AND INVESTMENT OFFICE
CONSULTING AND PROFESSIONAL SERVICES
AS OF JUNE 30, 2005

Actuary

Gabriel, Roeder, Smith & Co.
Dallas, Texas

Auditor

Brady, Martz & Associates, P.C.
Bismarck, North Dakota

Legal Counsel

North Dakota Attorney General's Office
Bismarck, North Dakota

Information Technology

CPAS Systems Inc.
Toronto, Ontario

MSI Systems Integrators
Omaha, Nebraska

Master Custodian

The Northern Trust Company
Chicago, Illinois

**Investment Consultant and
Performance Measurement**

Callan Associates Inc.
San Francisco, California

Investment Managers

Adams Street Partners, LLC
Chicago, Illinois

Bank of Ireland Asset Management
Chicago, Illinois

Bank of North Dakota
Bismarck, North Dakota

Brandywine Asset Management
Wilmington, Delaware

Capital Guardian Trust Company
Los Angeles, California

Coral Partners, Inc.
Minneapolis, Minnesota

Hearthstone Homebuilding Investors, LLC
Encino, California

INVESCO Realty Advisors
Dallas, Texas

InvestAmerica L&C, LLC
Cedar Rapids, Iowa

J.P. Morgan Investment Mgmt, Inc.
New York, New York

Investment Managers cont.

Lazard Asset Management
New York, New York

Loomis Sayles & Company
Boston, Massachusetts

Los Angeles Capital Management
Los Angeles, California

LSV Asset Management
Chicago, Illinois

Matlin Patterson Global Advisers LLC
New York, New York

Northern Trust Global Investments
Chicago, Illinois

Prudential Investment Management
Newark, New Jersey

RMK Timberland Group
Atlanta, Georgia

SEI Investments Management Co.
Oaks, Pennsylvania

State Street Global Advisors
Boston, Massachusetts

Timberland Investment Resources, LLC
Atlanta, Georgia

Trust Company of the West
Los Angeles, California

UBS Global Asset Management
Chicago, Illinois

The Vanguard Group
Valley Forge, Pennsylvania

Wellington Trust Company, NA
Boston, Massachusetts

Wells Capital Management, Inc.
Menomonee Falls, Wisconsin

Western Asset Management Company
Pasadena, California

Westridge Capital Management, Inc.
Santa Barbara, California

Certificate of Achievement for Excellence in Financial Reporting

Presented to
North Dakota
Retirement and Investment
Office

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2004

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Nancy L. Ziehl

President

Jeffrey R. Enos

Executive Director